

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

ORIGINAL

77-7104

To be argued by
SIDNEY B. SILVERMAN

United States Court of Appeals

FOR THE SECOND CIRCUIT

DAVID E. ROLF,

Plaintiff-Appellant

-against-

BLYTH, EASTMAN DILLON & CO., INC.,
and MICHAEL STOTT,

Defendants-Appellees,

and

AKIYOSHI YAMADA,

Defendant.

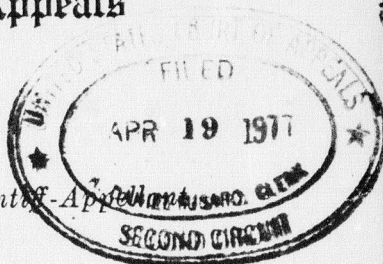
APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

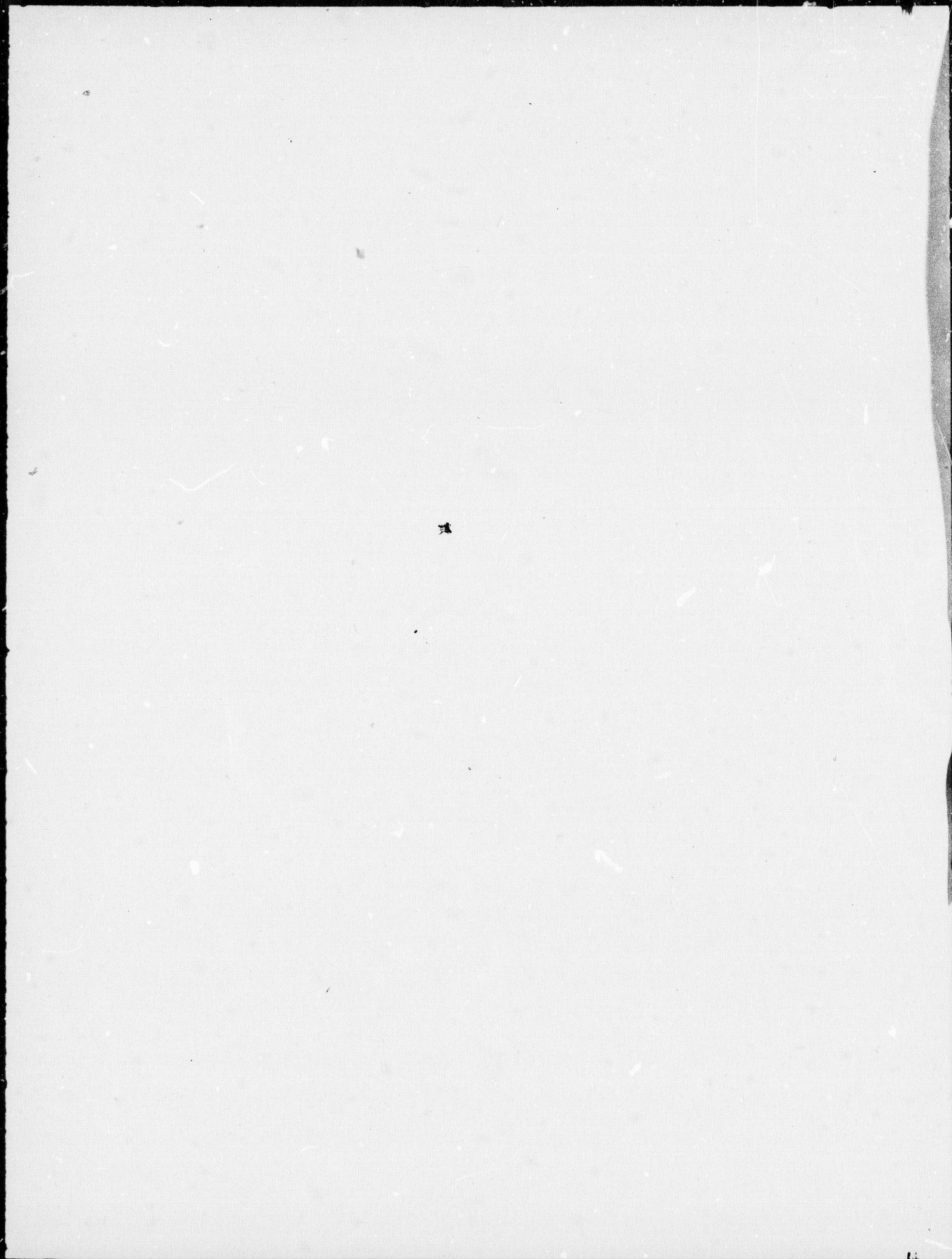
BRIEF FOR PLAINTIFF-APPELLANT

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DAVID E. ROLF, V. BLYTH EASTMAN DILLON & CO, INC. et al

SHORT TITLE

DOCKET NO. 77-7104

TYPE OF CASE
☐ U.S. Civil
☐ Bankruptcy
☐ Criminal
☐ Original proc.
☒ Private Civil
☐ Prisoner
☐ Administrative
☐ Other (specify)

DISTRICT COURT
☐ Conn.
☐ EDNY
☐ NDNY
☒ SDNY
☐ WDNV
☐ VT
☐ Other (specify)

MR NUMBER

T-7120

Forms	Date Filed	DOCKET FEE	DISTRICT COURT DATA:	☒ CROSS APPEAL OR ☐ CONSOLIDATED WITH DOCKET NOS. (& in 77-7124)
A		DATE 3-2-77	DISTRICT DOCKET NO. 73 Civ 2967	
B				
C	3-2-77	ACCOUNT OF APPELLANT	DATE ACTION FILED IN DIST. COURT 7-5-73	
D	3-2-77			
CJA20		RECEIVED \$50.00	DATE OF DISTRICT COURT JUDGMENT 2-2-77	RECORD FILED (ORIGINAL DIST. COURT PAPERS): 3-17-77
CJA23				
Other (specify)		DISBURSED	DATE N.A. FILED 2-22-77	(TRANSCRIPT(S)): 3-17-77
DATE(S) PREARGUMENT CONFERENCE(S) HELD:		NO FEE REQUIRED: ☐ FP ☐ 24a ☐ SC	DATE DOCKETED 3-2-77	

SCHEDULING ORDERS						FILING OF BRIEF, APPENDIX, ETC.		
SO 1	Adj SO 2	Adj SO 3	Adj SO 4	Adj SO 5		PAPER FILED	PARTY	DATE
DATE ISSUED 3-4-77	DATE ISSUED 4-14-77	DATE ISSUED 5-5-77	DATE ISSUED 6-29-77	DATE ISSUED 6-30-77		B	ant	4-19-77
Record 3-22-77						A-3	ant	4-19-77
Transcript						B	E	8-2-77
BRIEFS:						RB	T	10-5-77
Appellant No. 4-14-77	4-19-77							
Appellee No. 5-12-77	5-16-77	7-18-77	7-18-77	7-31-77				
Argument (Week of) 5-23-77	5-23-77	9-15-77	9-30-77	10-10-77				
		9-26-77						
☐ ADJ. SO, 6 ETC. OVER ☐ APPELLEE'S APPENDIX								

MOTIONS TO EXTEND TIME		CALENDAR		TERMINATION		METHOD OF DISPOSITION	
Date Filed	Order Entered	Date Time Request Sent	Date Heard/Submitted	Tape No.		☒ WRITTEN OPINION (BY JUDGE)	
		3-7-77	10-12-77	306-307		☐ WRITTEN OPINION (PER CURIAM)	
1		Date Disqualification Sent	Date Judgment Filed	Date Mandate Issued		☐ DECISION FROM THE BENCH	
2		4-27-77	1-3-78	12-8-78		☐ SUMMARY ORDER	
3		Date Certain Notices Sent (No. sent)	Date Bill of Costs Filed			☐ COURT ORDER W/O OPINION	
4		1 2 3 4 5 6	1-6-78			☐ DEFAULT DISMISSAL (CAMP, CAEP, OTHER)	
5		Receipt of Day	Date Statement of Costs Filed			☐ CONSENT DISMISSAL (RULE 33, CRIMINAL, OTHER)	
6		1 2 3 4 5 6	12-8-78			☐ 0.18(7) DISMISSAL	
7		Date Set for Argument	Petition for Rehearing Filed	Granted ☐		☐ OTHER (SPECIFY)	
8		10-12-77	Date	Denied ☐			
9			Date	Date			
10			☐ Additional Petitions for Rehearing-See Docket Entries			Record Returned 1-31-79	
Proceedings Held in Abeyance ☐	Reactivated ☐	Committed ☐	Petition for Certiorari Filed	Granted ☐		Receipt of Return of Records	
		Not Committed ☐	Date	Denied ☐			
Issuance of Mandate Stayed ☐	Stay Vacated ☐	ROR ☐	☐ Additional Petitions for Certiorari-See Docket Entries	Date		Date Reopened	
		Bail ☐					

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United States Court of Appeals

FOR THE SECOND CIRCUIT

DAVID E. ROLF,
Plaintiff-Appellant,
against

BLYTH, EASTMAN DILLON & Co., INC.
and MICHAEL STOTT,
Defendants-Appellees

and
AKIYOSHI YAMADA,
Defendant.

DOCKET No.
77-7104

*Appeal from the United States District Court
for the Southern District of New York*

BRIEF OF PLAINTIFF-APPELLANT

Preliminary Statement

Plaintiff appeals from a judgment entered on February 3, 1977, following a non-jury trial before the Honorable Lawrence W. Pierce.

Judge Pierce found that plaintiff had been defrauded by defendants in connection with the purchase and sale of securities. The court further found that plaintiff "was damaged as a proximate result of the defendants' fraud." Nevertheless, Judge Pierce limited plaintiff's recovery to \$55,790, the amount of brokerage commissions and interest paid by him during the relevant period. Judge Pierce denied recovery of any part of the actual trading losses of approximately \$1,120,000 sustained by plaintiff. Plaintiff's claim on appeal is that in denying plaintiff compen-

sation for the injury caused him by the defendants' fraud, the court below erred in its award of damages.

Judge Pierce's opinion is reported in 424 F. Supp. 1021 and is reproduced in the Joint Appendix on pages JA 17 through JA 76.

STATEMENT OF ISSUE PRESENTED FOR REVIEW

Is a customer who has been defrauded by a registered representative and his firm and has suffered actual injury as a result thereof, entitled to recover trading losses stemming from the fraud, or is his recovery limited to commissions and interest paid to the brokerage firm?

STATEMENT OF THE CASE

Plaintiff, a physician, entrusted to defendants Akiyoshi Yamada (Yamada)* and Michael Stott (Stott) the management of plaintiff's portfolio of securities having a market value of approximately \$1.4 million. Stott was a registered representative employed by Eastman Dillon & Co. (Eastman Dillon), a predecessor of Blyth Eastman Dillon & Co., Inc. (BEDCO) and Yamada, a young man of twenty-six, was a self-employed investment adviser recommended to plaintiff by Stott. Stott and Yamada, in a period of less than twenty months, virtually devastated plaintiff's entire portfolio, reducing it from its initial value of \$1,423,000 to a worth of only \$225,000. (JA 19).

Plaintiff claimed that his losses were occasioned by the fraudulent and deceptive actions of defendants in violation of the antifraud provisions of the Federal Securities Laws

* Plaintiff discontinued his action, without prejudice, as against Yamada, in return for Yamada's waiving a Fifth Amendment privilege and testifying fully and truthfully at the trial. (E-21-23) (All page references to the volume of Trial Exhibits are preceded by "E").

and the rules and regulations of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). Defendants Stott and BEDCO did not contest plaintiff's claim that he had been victimized by fraud, but urged that Yamada, alone, was the responsible party. In seeking to relieve themselves of blame, Stott and BEDCO attempted to portray their role as that of mere "order takers" who were not involved in the fraud.

At the trial, the testimony of the parties often presented conflicting versions of what had transpired. Judge Pierce, in a carefully constructed 160 page opinion, resolved all conflicts. His conclusions were based upon the nature of the testimony itself, documentary evidence and the court's evaluation of the overall credibility of the witnesses and their demeanor. The court found that Yamada, the plaintiff's investment adviser, had committed a "gross fraud" upon plaintiff in the management of his account, in violation of Rule 10b-5, and that Stott, the plaintiff's broker, with actual knowledge of the wrong and acting with *scienter*, had engaged in a "hand holding operation" which was, "under the circumstances, a fraud upon the plaintiff" and a violation of Rules 10b-5 and 15c1-2. Thus, the court held, Stott's continued expression of confidence in Yamada and his investment decisions "constituted a fraud upon Dr. Rolf who sincerely believed that Stott had some basis for his statements." Judge Pierce also held that Stott and BEDCO had violated the aforesaid rules by engaging in conduct which violated NYSE Rule 405(1) and (2) and Article III, § 2 of the rules of the NASD. Such conduct, the court stated, constituted:

"a knowing, willful and reckless disregard for the truth, a callous and knowing disregard for the requirements of the NYSE and NASD rules involved herein, and proof of the *scienter* element by a fair preponderance of the credible evidence."

The court further concluded that as a result of his false representations, his cover-up of improper investment decisions made by Yamada and his trading of the plaintiff's stocks with no "thought as to their suitability", Stott was liable as an aider and abetter of "Yamada's fraudulent violation of his own duties as an investment adviser."

Judge Pierce found that BEDCO had failed to supervise Stott or to provide "even minimally sufficient safeguards to protect the investor from the type of fraud present in this case." Accordingly, the court below held BEDCO liable as a controlling person under § 20 of the Exchange Act (15 U.S.C. § 78t) as well as under the common law doctrine of respondent superior.

Having concluded that plaintiff was a victim of the defendants' fraud, the court next considered the issue of damages. Judge Pierce found that the unlawful and fraudulent activities engaged in by defendants in connection with the purchase and sale of securities for plaintiff's account were the proximate cause of injury to plaintiff. The court stated:

"Plaintiff has established that the acts of the defendants were a substantial or proximate cause of the placing of unsuitable securities in his BEDCO account. Stott's conduct and BEDCO's failure to supervise created a continuous and active potential for harm to the plaintiff, see *Miller v. Schweickart*, 413 F. Supp. 1062 (S.D.N.Y. 1976), and it is clear that plaintiff was damaged as a proximate result of the defendants' fraud."

The court, however, declined to award plaintiff, as damages, any part of the losses sustained by him through the purchase and sales of securities for his account. Judge Pierce reasoned that an award of such losses would be "speculative". The court thereupon held that defendants

need only return to plaintiff \$55,790, a sum which represented brokerage commissions and interest expense charged on plaintiff's margin account, with interest from the date of judgment.*

Thus, although holding plaintiff to be the victim of "gross fraud", the court below eliminated from the calculus of damage, all trading losses sustained in plaintiff's account. As a result, the damages awarded bear no reasonable relationship to the wrongs engaged in by the defendants and the actual losses inflicted upon plaintiff. Plaintiff submits that he is entitled to recover his trading losses, with prejudgment interest, thereby being placed in the position he would have occupied "but for" the defendants' fraud, and that the decision below should be modified to permit such recovery.

STATEMENT OF FACTS

A. Plaintiff's Securities Account Prior To Management By Yamada-Stott.

Plaintiff is a surgeon specializing in ophthalmology. He resides in Cleveland, Ohio. In 1950, plaintiff began investing in the stock market a portion of the money earned by him in the practice of medicine. In the beginning, the plaintiff relied upon advice from brokers in Cleveland as to which securities to buy or sell. However, in time, the doctor

* Although the plaintiff briefed the appropriateness of prejudgment interest, the court below did not discuss the point and plaintiff is therefore unaware of any basis for rejection of prejudgment interest. An award of interest from the date of judgment would appear to be superfluous in view of the automatic application of interest to any judgment.

became dissatisfied with such an arrangement. He found that calls from brokers during the day disrupted his practice and that his account which had grown to \$400,000 (principally as a result of contributions made by him), did not receive the care and attention which he deemed necessary. (JA 20-21) Accordingly, the doctor decided to seek an investment adviser in New York to manage his portfolio. After a brief period with one such investment adviser, the plaintiff selected S. Logan Stirling (Stirling), a partner in Eastman Dillon, to manage plaintiff's account. Plaintiff's account remained under the management and control of Stirling from September, 1963, to mid-March, 1969. (JA 20-22, 26) Plaintiff was pleased with Stirling's management and the portfolio, from year to year, increased substantially in value through investments made in sound securities.

In mid-March, 1969, Stirling became totally disabled and he died several months later. (JA 26) BEDCO did not inform plaintiff that Stirling had become disabled until the end of April. For a period of approximately six weeks, plaintiff's account was, unknown to him, unsupervised. (JA 26) Yet, during this period three transactions were effected for plaintiff's account by an unknown person at BEDCO who lacked authority to buy and sell securities for plaintiff. The transactions involved the sale of one thousand shares of Occidental Petroleum Corp., the sale of one thousand shares of Talcott National Corp., and the purchase of one thousand shares of Asamera Oil Corp. (JA 26).

B. Plaintiff Retains Stott And Yamada To Manage His Account.

After plaintiff had been notified of Stirling's illness, Stott called plaintiff and stated that his account had been reassigned to Stott to "handle." The plaintiff learned

that Stott was an experienced broker, but that he was neither a security analyst nor a partner of Eastman Dillon. Plaintiff informed Stott that plaintiff desired that his account be managed by a partner of Eastman Dillon or an investment adviser. (JA 26) Several days later, Stott called plaintiff and recommended two investment advisers, one of whom was Yamada. Plaintiff was impressed with Yamada, who appeared to be "brilliant." However, plaintiff was disturbed both by Yamada's youth, which indicated to plaintiff a lack of experience, and by the fact that Yamada was not associated with an established firm. (JA 27).

Despite certain reservations about Yamada, plaintiff, on May 9, 1969, executed a power of attorney in Yamada's favor. However, before doing so, plaintiff took steps to provide for the supervision of Yamada by Stott and BEDCO. (JA 28-29) Plaintiff instructed Yamada to effect all purchases and sales, if possible, through Stott and BEDCO (JA 91) and informed Stott that he would earn commissions in return for supervising Yamada's activities. (JA 29, 30). Further, plaintiff determined to leave his portfolio of securities in BEDCO's custody. (JA 30) At the trial, the court below credited the doctor's testimony that he believed that by combining Stott and Yamada he could obtain a "Stirling-type" operation and refused to accept Stott's testimony that he was only an "order taker". (JA 28, 29, 40, 46, 56) Thus, the court below stated:

"Rolf believed that Stott was intimately involved with the management of the account. Indeed, since Stott and Yamada were in daily contact discussing securities which ended up in the plaintiff's account, Rolf's was a reasonable belief. It was moreover a correct belief; Stott *was* involved with the management of the account." (emphasis in original). (JA 36).

C. In Their First Eight Months, Stott And Yamada Liquidate Plaintiff's Portfolio And Reinvest The Proceeds, Incurring A Loss of \$711,000 In The Process.

In May of 1969, at the time Stott and Yamada commenced their activities, plaintiff's account consisted of the following securities:

Anaconda Co.
 Asamera Oil Corp.
 Avnet Inc.
 Buttes Gas & Oil Co.
 CNA Financial Corp.
 Cities Service Co.
 Ebasco Industries, Inc.
 Glen Alden Corp.
 INA Corp.
 International Industries Inc.
 General Electric Co.
 Leasco Data Processing Wts.
 Leeson Corp.
 Levin Townsend Computer Corp.
 Loew's Theatres Inc.
 Loew's Theatres Wts.
 National General Corp.
 Occidental Petroleum Corp.
 Penn Central Co.
 Pittson Co.
 Raytheon Corp.
 Scientific Resources Corp.
 Teledyne, Inc. (JA 30)

All of the securities listed above, represented interests in established companies, 18 of which had had at least five continuous years of profitable operations. (JA 31) Sixteen paid dividends, two since the mid-19th century. The plaintiff's expert graded 15 as high quality or "blue chip" and three, on the borderline of high quality. (E 190-191, JA 354).

On May 9, 1969, plaintiff's equity in the above listed securities was \$1,423,000 (JA 32). Twenty-one of the securi-

ties were sold within a few months and the remaining two securities were liquidated by January, 1970. Thus, the plaintiff's entire portfolio was liquidated within a period encompassing the first eight months of the Yamada-Stott management of plaintiff's account.* By the end of the eight month period, plaintiff's equity had declined to \$712,000 and he had therefore, lost \$711,000. (JA 37).

The fraudulent activities of Yamada and Stott commenced with the liquidation of plaintiff's portfolio. High quality securities were quickly and indiscriminately sold and replaced by securities which plaintiff's expert labelled "lowest of the low" and Stott recognized as "junk." Many of such securities were purchased for plaintiff in aid of manipulative activities engaged in by Yamada. Other transactions were effected to generate commissions for Stott who threatened to inform plaintiff that "junk" securities were being purchased on his behalf unless Stott received substantial commission income. Still other transactions were made through firms other than BEDCO to repay obligations owed to such firms by Yamada.

The trading pattern, which in the first eight months was to compile losses of \$711,000, continued throughout the entire 20 month period of the defendants' handling of the plaintiff's account, producing overall losses for plaintiff of approximately \$1,120,000.

D. The Policies And Practices Of Yamada And Stott In the Management of Plaintiff's Account Were Based on Fraud.

As the court below found, the handling of plaintiff's account was "generally of a fraudulent nature." Yamada did not make investment decisions based upon the particular

* The court below found that it was during this eight month period that Stott was most intimately involved in the management of the plaintiff's account.

needs and requirements of the plaintiff, but rather used his account to provide "buying power" for various market manipulative schemes (JA 64). Thus, over the twenty month period, Yamada's principal purchases for plaintiff's account consisted of stocks of companies having little or no earnings or history of operations. Among the securities purchased by Yamada were the following:

Creative Polymer Products
Delanair, Inc.
GPI Enterprises
Hair Extension Center
Health Evaluation Systems
Holobeam, Inc.
International Health Services
Synchromex Corp.
Tele-Communications
Tranquilaire Mental Health
Visual Sciences, Inc.
Viatron Computer Bonds (JA 37, 43,
64, 400, 405, 406).

All of the above were graded by plaintiff's expert as "lowest of the low." (E15-16) Seven of the 12 were, according to Yamada's own testimony, securities which he was manipulating. (JA 38). Thus, in managing plaintiff's account, Yamada gave no consideration to plaintiff's legitimate needs and expectations. Instead, he employed plaintiff's account as a manipulative "tool", using the plaintiff's large portfolio to purchase securities having no investment merit. (JA 69).

Stott, commissioned by the plaintiff to supervise the activities of Yamada, was, the court below found, fully aware that Yamada was purchasing "junk" for plaintiff's account. Nevertheless, Stott "continually" assured plaintiff that the securities purchased for him by Yamada were suitable investments. (JA 69). Indeed, the court below found that Stott was assigned by Yamada, and accepted the

task of convincing the plaintiff that, contrary to the truth, his account was being properly managed and that Yamada was a suitable investment adviser. The court found Stott's successful "hand-holding operation" to constitute "a fraud upon the plaintiff."

While Yamada's major interest in plaintiff's account was its use in the furtherance of manipulative schemes, Stott saw it mainly as a source of commissions. Thus, although Stott admitted that he did not know plaintiff's investment objectives and made no effort to determine them, he recommended the purchase of 12 stocks for plaintiff. (JA 46, 34). The securities recommended by Stott were, with one exception, sold shortly after their purchase.* (E28-31). Indeed, four were sold within a month of their purchase. (E28-31) The quick turnover in the stocks purchased by Stott for plaintiff was never explained by the defendants. Although Judge Pierce found the turnover rate on an annual basis to be below that required to establish churning, the evidence that Stott's recommendations were designed solely to generate commission income was never rebutted. (JA 381).

Although plaintiff had retained Stott only to supervise Yamada's activities and did not wish his recommendations to control the purchase and sale of securities for plaintiff's account, nevertheless, more than 25% of the stocks purchased for plaintiff's account during the 20 month period were purchased by Stott. On none of the stocks purchased at Stott's behest did plaintiff make any profit, and on four, he lost an aggregate of \$65,000. (JA 38). Although there was no evidence that the stocks purchased by Stott to generate commission income were unsuitable for plaintiff, such purchases were made in violation of Stott's authority, were quickly sold, and, in every instance, resulted in losses for plaintiff.

* The exception was Equity Funding which was sold within 10 months of its purchase at a loss of \$47,000.

E. BEDCO Failed To Supervise Plaintiff's Account.

BEDCO, as Stott's employer, was a "controlling person" under § 20(a) of the Exchange Act and thus, jointly liable for plaintiff's injury with Stott unless it could establish a "good faith" defense. The court below weighed the evidence as to whether BEDCO had exercised "good faith" and concluded that BEDCO's "complete failure" to supervise plaintiff's account, its laxness, particularly in allowing the account to be traded by an unauthorized person* and its failure to establish "even minimally sufficient safeguards" to protect the plaintiff, completely negated any claim that BEDCO had acted in "good faith" (JA 71-72). Indeed, the court found that all of BEDCO's control procedures had been "jettisoned" in the plaintiff's case. (JA 71).

The court's finding that BEDCO had failed to exercise "good faith" was adequately supported by the record. Although within a period of eight months, a customer of long standing had had his equity reduced in half as a result of the complete liquidation of his portfolio and the purchase of "junk", BEDCO made no inquiry, whatsoever, concerning the plaintiff's account. (JA 893-894, 918) An inquiry by BEDCO would have revealed not only that Stott had recommended Yamada to plaintiff as a suitable investment adviser but also, as found by the court, that Stott had "influenced Yamada's decision-making and recommended to Yamada stocks for Rolf." (JA 56). Although evidence of unsuitable investments appeared every month, BEDCO chose to ignore it. Thus, it failed to discover that in the first eight months following the assignment of the plaintiff's account to Stott, contrary to the policy of the firm, he had been trading in low quality and highly speculative stocks,

* From mid-March, 1969, to the end of April three trades were made in plaintiff's account by an unidentified and unauthorized person. (JA 26, 72).

and concomitantly, plaintiff's liquid assets had been substantially reduced. (JA 47-48).

Although the plaintiff's account at BEDCO was pillaged and destroyed, BEDCO's compliance department exercised no surveillance over Stott's activities in connection with the account. Such failure to supervise, coupled with the unauthorized trading in plaintiff's account effected during the period of BEDCO's sole stewardship, provided an adequate basis for the court's finding that BEDCO had failed to establish a "good faith" defense. (JA 72).

BEDCO's liability was also established under the common law doctrine of respondeat superior.

F. Stott's Fraud And Deception Continued After The Cessation Of Trading.

Stott's fraud did not end with the cessation of trading in plaintiff's account, but continued throughout the litigation, as Stott perjured himself in an unsuccessful attempt to conceal his true role. In a pre-trial deposition, Stott testified that he spoke with Yamada only twenty or thirty times during the relevant twenty month period and then only to receive orders as to the purchase or sale of stock. (JA 31). After Yamada had testified that Stott had a direct telephone line to Yamada, Stott admitted that his depositions testimony was false (JA 660-661) and that he had spoken with Yamada at least once a day. (JA 619, 31).

On April 10, 1970, in another attempt to exculpate himself, Stott wrote a letter to plaintiff claiming to be "only an order taker," and alleging that he had "nothing to say over the handling and management of this account." (JA 48). The letter was patently false and self-serving. Based upon credible testimony, the court below concluded that Stott was "indeed involved with the management of [plaintiff's] account." Thus, the court below found that Stott's letter to plaintiff was false and designed to prepare a defense to this action.

Stott testified at the trial, that he recommended six stocks for plaintiff's account.* (JA 634-635, 808-809). However, based upon other, more credible evidence, the court below found that he recommended 12 stocks. (JA 32). Four of the six stocks which Stott denied recommending resulted in losses to plaintiff of \$65,000. Thus, it appears that Stott thoroughly considered his testimony beforehand with an eye toward the limitation of possible damages.

Stott committed two wrongs against plaintiff. The first consisted of conduct which defrauded plaintiff in connection with purchases and sales of securities. The second consisted of Stott's falsehoods, designed to conceal his fraudulent activities. The first wrong resulted in loss to plaintiff of \$1,120,000; the second, in the necessity to dismiss the action against Yamada, in order to place the true facts before the court.

G. The Evidence Supports The Finding of The Court Below of Liability Against Stott and BEDCO.

Judge Pierce expressly found that Stott acted willfully and with *scienter* in violating Rule 10b-5 and Rule 15c1-2 and in aiding and abetting Yamada's violation of Rule 10b-5. The record provides substantial evidence to support Judge Pierce's finding. Stott knew that Yamada was purchasing "junk" for plaintiff, but nevertheless, informed him that the securities being purchased for him were proper. (JA 42). Other evidence in the record demonstrates that Stott threatened Yamada that unless Stott received more commission business, he would inform plaintiff that junk was being purchased in his securities account. (JA 406-408). Based upon "all the evidence in the case as well as upon the court's assessment of Stott's demeanor and credibility,"

* Such testimony was inconsistent with his claim of being merely an "order taker".

Judge Pierce concluded that Stott acted willfully and with scienter.* (JA 66).

The court below specifically found liability against Stott for violating Rules 405(1) and (2) of the New York Stock Exchange and Article III, Section 2 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. Moreover, the court below found that the violation of such rules was caused by conduct so heinous as to be "tantamount to fraud" and to constitute a violation of Rules 10b-5 and 15c1-2. Thus, although other circuits have held that violations of the rules involved herein may give rise to a private right of action and district courts within this circuit have so held, this court need not decide such issue as part of this appeal, since the court below found that the conduct violating the rules also constituted a violation of Rules 10b-5 and 15c1.**

The conclusion reached by Judge Pierce that Stott acted as an aider and abettor of Yamada's fraud was based upon findings that Stott, acting with knowledge and *scienter*, "rendered substantial assistance" to the primary wrong-

* It was apparent at the trial, from the personalities of Yamada and Stott that the word "junk" was a euphemism for a more vulgar word. Stott craftily attempted to avoid the thrust of Yamada's testimony that Stott had threatened to inform the plaintiff that his account was being mismanaged, by stating that he never used the word "junk." But Stott did not testify that he never used any other word of similar import. Accordingly, Judge Pierce found that Stott did not fairly deny the evidence that he knew the securities were "junk". Indeed, in view of the fact that securities such as Hair Extension Centers, Tranquilaire Mental Health and Health Evaluation Systems were purchased for plaintiff, it is highly unlikely that an experienced broker such as Stott would not know that such securities were "junk."

** The order and judgment submitted by plaintiff's counsel was changed by Judge Pierce to reflect that the flagrant violation of the rules of the New York Stock Exchange and the National Association of Securities Dealers, Inc. constituted a violation of Rules 10b-5 and 15c1-2.

doer, Yamada. The court found that "(b)y continually holding Rolf's hand and assuring him that Yamada's decisions were appropriate, Stott substantially diminished any opportunity for an earlier discovery by Rolf of Yamada's true intentions. By failing to recommend against any venture and by failing to question Yamada's suitability as an adviser, Stott contributed to the perpetration of the depletion of Rolf's account and the accumulation of unsuitable securities therein."*

Although the issue of whether a broker-dealer may have responsibility to a customer in situations in which the customer has engaged an investment adviser and such adviser, alone, influenced and controlled the account, is a novel one, this court need not concern itself with such issue. The court below found that Stott agreed to supervise Yamada's handling of the plaintiff's account, that Stott actually involved himself in the management of that account, that Stott repeatedly advised plaintiff that his account was being properly managed when, in fact, he knew that it was not, and that Stott refrained from telling the truth to plaintiff in consideration for brokerage commissions. Whatever the responsibility of an innocent and uninvolved broker may be for an account which has been mismanaged by an investment adviser, in light of Stott's culpability and involvement, such an issue is not raised herein.

The court's conclusion that BEDCO is liable as a controlling person rests upon substantial evidence and well-established principles of law. Section 20(a) of the Exchange Act makes a controlling person liable for the acts of a controlled person unless the controlling person can prove "good faith". BEDCO is clearly a controlling person and Stott a controlled person. The court below

* That aider and abettor liability exists under Rule 10b-5 cannot be fairly questioned in view of the recent decision of this court in *Securities and Exchange Commission v. Universal Major Industries Corp.*, 546 F.2d 1044 (2d Cir. 1976), and the views of various courts which have had occasion to pass upon aider and abettor liability under the Federal Securities Laws.

found that BEDCO failed to exercise "good faith", stating that:

"[BEDCO's] complete failure to supervise any such accounts, and its laxness which went so far as to permit Stott to recommend an investment adviser with no knowledge of Dr. Rolf's account and even further to allow some *unidentified* person to trade in Rolf's account during April 1969, all lead the Court to the conclusion that BEDCO did not, during the period in question, establish even minimally sufficient safeguards to protect the investor from the type of fraud present in this case. Accordingly the good faith defense has not been established."

The court below also concluded that liability could be imposed upon BEDCO based upon the common law doctrine of respondeat superior. Although this court has not passed upon whether such doctrine should apply in a private action, it has held the doctrine applicable in SEC enforcement proceedings.* Other circuits which have had occasion to decide the issue have held that the doctrine of respondeat superior should apply to private actions brought under the Federal Securities Laws. (See cases cited at JA 69-70).

Thus, plaintiff believes, the record conclusively establishes the validity of the court's finding of liability on the part of the defendants and, thus, the only issue appropriate for review on this appeal is whether Judge Pierce correctly awarded damages.

H. The Plaintiff's Losses Caused By The Fraudulent Activities Of Stott And Yamada Can Be Measured.

Plaintiff sustained injury because his portfolio was fraudulently mismanaged. The fraudulent activities commenced in mid-March, 1969, when plaintiff's portfolio, placed

* *SEC v. Geon Industries Inc.*, 531 F.2d 39 (2d Cir. 1976); *SEC v. Management Dynamics*, 515 F.2d 801 (2d Cir. 1975).

in BEDCO's custody, was unsupervised and an unidentified and unauthorized person effected transactions therein. Beginning in May, 1969, plaintiff's portfolio was thoroughly exploited and pillaged through the joint efforts of Yamada and Stott. The actual losses sustained by plaintiff are a matter of simple mathematical computation, based upon the record in this case and are, in no respect, speculative.

Losses accrued as a result of three separate, but related events: the liquidation of plaintiff's portfolio, investments made by Yamada and investments made by Stott.

Plaintiff sustained a loss of \$427,000 from the liquidation of his portfolio. In May, 1969, the portfolio was worth \$1.4 million. (JA 31). The securities were sold for proceeds which, after adjustment for plaintiff's margin account, yielded \$427,000 less than the market value of the securities in May of 1969. (E 26-31).

On the 25 investments made by Yamada for plaintiff, he sustained a loss of \$529,000. (E 26-31) Twenty four investments involved the purchase of securities upon which plaintiff had a realized loss of \$106,000 and an unrealized loss of \$325,000. The twenty-fifth investment was in a hedge fund run by Yamada in which plaintiff lost \$98,000.*

The 12 stocks purchased for plaintiff as a result of Stott's influence produced a realized loss for plaintiff of \$162,000 and an unrealized loss of \$12,000. (E 26-31).

The total losses exclusive of brokerage commissions and interest (which aggregated \$55,790), amounted to \$1,130,000. The damage computation is made from trial exhibits. Confirmation of every trade and monthly statements are part of the record. In addition, plaintiff's ex-

* Plaintiff invested \$257,000 in Monarch Industries which was sold two months after its purchase for \$98,000. The \$98,000 investment made in the Hedge Fund came from the proceeds of the sale of Monarch Industries. (E 26-31)

pert, marked to market the portfolio for each month. (E 131-181) Finally, plaintiff submitted a detailed schedule reflecting the information contained on the confirmations and monthly statements. (E 26-31). The realized and unrealized losses described above were obtained from an examination of such records and plaintiff believes that they have been accurately calculated.

ARGUMENT

I

PLAINTIFF SUSTAINED ASCERTAINABLE DAMAGE AS THE PROXIMATE RESULT OF THE DEFENDANTS' FRAUD THE COURT BELOW ERRO- NEOUSLY FAILED TO COMPENSATE PLAINTIFF FOR SUCH DAMAGE.

After trial, the court below "readily conclude[d] that the actions of the three defendants operated as a fraud upon Dr. Rolf". However, although it found that the plaintiff suffered "actual injury" as the proximate result of the aforesaid fraud, the court failed to award damages which were in any way consistent with its finding. Such failure, plaintiff contends, constitutes reversible error.

The court's findings with respect to fraud and damage were not vague or uncertain in nature. Indeed, the court specifically held: (1) that the defendant "Yamada's handling of the Rolf account was generally of a fraudulent nature." (2) that the purchase of Delanair, and the purchase of unsuitable securities in the furtherance of manipulative schemes, resulting in "the complete transformation of the Rolf account from one containing 23 listed issues of reputable quality to an account made up of" securities categorized as junk, "constituted a gross fraud." (3) that the "plaintiff ha[d] established that the acts of the defendants were a substantial or proximate cause of the placing of un-

suitable securities in his BEDCO account," (4) that Stott's "hand holding" operation, engaged in "with wilfull and reckless disregard for the truth," constituted conduct "tantamount to fraud," since that defendant's actions "deceived plaintiff into thinking" that his interests were being protected and operated "to help conceal" from him the fraud being perpetrated upon him; and (5) that "Stott's conduct and BEDCO's failure to supervise created a continuous and active potential for harm to the plaintiff . . . and that it is clear that plaintiff was damaged as a proximate result of the defendants' fraud."

Despite the fact that, as shown above, the court clearly spelled out the defendants' fraudulent conduct and held that plaintiff was damaged as the proximate result thereof, plaintiff was, nevertheless, awarded as damages only the commissions charged by defendant BEDCO and the interest on plaintiff's margin account. Thus, although he lost approximately \$1,120,000,* virtually his entire life savings, during the period that he was the victim of the defendants' fraud, plaintiff recovered merely \$55,700, the "monies paid to the defendants Stott and BEDCO during the period in question". The court deemed this meager award "logical," rejecting all other measures of damage as "wholly speculative" with respect to the injury sustained by plaintiff as a result of the defendants' actions. The court based its refusal to compensate plaintiff for any damages sustained by him upon the conclusion that his injury was not caused in its entirety by the defendants' fraud, but was suffered in part as a result of poor investment decisions and a bear market. Thus, the court declared, since factors other than the defendants' fraud contributed to the plaintiff's damage, it would be "inappropriate" to allow him to recover any of

* \$175,000 was subsequently recovered in settlement of a lawsuit involving the Delanair purchase. The defendants herein were not parties to that settlement. Losses of \$1,120,000 give the defendants credit for plaintiff's partial recovery with respect to Delanair.

his losses. Plaintiff submits that in so holding, the court was in error, since, as shown below, all the damages suffered by plaintiff were proximately caused by the defendants' fraud. Moreover, even if factors other than the defendants' fraud be deemed responsible to some extent for plaintiff's injury, the scope of the damage caused by such factors can be ascertained and liability therefor can and should be apportioned between them. Plaintiff contends that the court below improperly applied the law of causation and assessed damages so as to achieve both an erroneous and unjust result.

A. Plaintiff Is Entitled To Recover All Losses Which Proximately Resulted From The Defendants' Fraud.

This Circuit has held that "[t]he federal securities laws require a high state of honesty and morality of brokers and dealers in transactions with customers." Where a broker or dealer has violated § 10(b) of the Securities Exchange Act in connection with a customer's purchase of securities, the customer may recover from his broker "any loss proximately resulting" from the latter's unlawful conduct.* The conclusion that in the event of a broker's fraud, the plaintiff may recover for damage of which such broker's conduct was the proximate cause,** is consistent with the

* *Smith v. Bear*, 237 F.2d 79, 87, 88 (2d Cir. 1956).

** One court has read this Court's decision in *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) to hold that "the causation required is simply that the action on defendant's part, which is alleged to have violated Rule 10b-5, must have been relied upon by plaintiff when he entered the transaction." *Robinson v. Cupples Container Co.*, 316 F. Supp. 1362, 1366 (N.D. Cal. 1970). Plaintiff contends that that definition of causation is also met by the facts of this case since the court below found that the plaintiff's reliance on the defendants' representations caused him to believe that his interests were being protected and prevented him from discovering the fraud being perpetrated on him.

tendency of the courts to view 10b-5 suits as essentially tort litigation.*

In a tort action, as a general rule, one injured by the commission of fraud is entitled to recover such damages as will compensate him for the loss or injury actually sustained and place him in the same position he would have occupied, had no fraud occurred. Damages which were natural and proximate consequences of the fraud are recoverable.

Although the general tort rule is a simple one, its application may be complex, and difficulty often arises in determining the question of proximate cause, i.e., to which factors the plaintiff's loss might and should be ascribed. Moreover, such a determination is more difficult in the context of litigation such as a securities fraud case, since judicial interpretation of the doctrine of causation has almost invariably been expressed in terms of automobiles, boats, bullets, wounds, fires, and accident inducing conduct. Nevertheless, although no precise measure of proximate cause has been established, and in dealing with causation, the courts have made use of varying tests, certain basic principles have evolved. Plaintiff contends, as discussed below, that proper application of such principles to the facts of this case, mandates the recovery by plaintiff of all his trading losses or a substantial portion thereof.

1. Defendants' Unlawful Conduct Was The Proximate Cause Of All The Plaintiff's Losses.

a. The Law Of Causation.

The law of causation, stated in general terms, requires that there be some "reasonable connection" between the act or omission complained of on the part of the defendant and the damage which the plaintiff suffered and "[t]his

* See, e.g., *J. I. Case & Co. v. Borak*, 377 U.S. 426 (1964).

connection usually is dealt with by the courts in terms of what is called 'proximate cause.' However, despite the innumerable attempts which have been made to clarify the subject, no precise standard has been articulated for the determination of what constitutes proximate cause and no "general agreement" has been reached as to the proper approach to the term's definition.*

Proximate cause is the limitation which the courts have placed upon the actor's legal responsibility for the consequences of his conduct and such responsibility has been limited to those causes which are "reasonably" connected with the result and of such significance that the law is justified in imposing liability. Such limitation, however, is more often influenced by matters of policy than of causation.

As one commentator has observed, since "[s]ome form of causation is involved in every law suit . . . [o]ne might expect, therefore, that after so many centuries of litigation jurists would have a pretty clear idea of what causation really is."*** However, the concept of cause, which has undergone drastic revision in the sciences, has never been clearly defined, and "judgments of causation in the law are relative and changing."**** Judgments of causality vary with the viewpoint of the observer and the objectives and value orientation of the court. A determination of proximate cause, thus, involves not only time, space and mechanical factors, but also "a balancing of considerations which tend to show that it is, or is not, reasonable or just to treat the act as the cause of the harm, that is, upon a

* Prosser, Torts (4th Ed. 1971) 236. As Commissioner Sommer once noted, Prosser has "nicely reconciled" much of the "melange of tort law." *Professional Responsibility: How Did We Get There*, 30 Bus. Law 95 (1974).

** Cohen, *Field Theory and Judicial Logic*, 59 Yale L. J. 238,251 (1950).

*** *Id* at 257.

balancing of conflicting interests, individual and social.”* Thus, although damages to a plaintiff may in reality be the result of “the intersection of an infinity of strands of occurrences . . . [w]hat we do when we look for legal cause is to pick out of this infinity of intersecting strands a useful point at which public pressure can be placed. We think the imposition of pressure at that point will tend to bring about either a better course of conduct on the part of the defendants or a fair measure of relief for plaintiffs. What we will take to be the cause of an accident, then, is not determined entirely by the objective facts. The standards of conduct applied to the situation are an integral part of any judgment of legal causation.”**

As Prosser has observed, the search for some test or formula which will serve as a “universal solvent” for all the problems of proximate cause has occupied many writers. Although “dozens of touchstones and panaceas” have been proposed, no universally accepted definition has emerged and “no judicial yardstick for determining proximity has yet been (and it is believed by some cannot be) devised.”*** Most popular have been the definition of the Restatement of Torts which defines proximate cause as that which is “a substantial factor in bringing about the harm” complained of**** and the “probable consequence” doctrine which provides that a cause is proximate if the injury of which the plaintiff complains is the “natural and probable” consequence of the defendant’s act.***** Prosser and others view

* Edgerton, *Legal Cause*, 72 U. Pa. L. Rev. 211, 343 (1924).

** Cohen, *op. cit.* at 252, 253.

*** One authority states that “what is necessary for causation is not, as is commonly stated, natural and probable cause, but probable natural cause.” McLaughlin, *Proximate Cause*, 39 Harv. L. Rev. 149, 184 (1925).

**** Prosser, *op. cit.* 236.

***** Note, *Theories of Proximate Causation*, 4 U. Cinn L. Rev. 118, 119 (1928).

the determination of the question of proximate cause as one encompassing a series of distinct issues, two of which plaintiff contends, are applicable to the facts herein:

1. Causation in fact—did the defendants' conduct play a significant part in bringing about the plaintiff's injury?

2. Apportionment of damages—if the plaintiff's injury has been caused by the defendants' acts and other causes, what portion of the total harm is properly assignable to the defendants.*

Each will be separately discussed below.

i. Causation In Fact Has Been Shown: The Defendants' Conduct Played A Substantial Part In Bringing About The Plaintiff's Loss.

Causation is a term which, in theory, includes all factors which contributed to the injury complained of. However, remote factors are ignored by the courts and it would appear to be the general rule that if the defendants' act or omission was a substantial factor in bringing about the result complained of, it will be regarded as a cause in fact. The plaintiff is not required to establish the fact of causation with absolute certainty or "beyond a reasonable doubt."*** Indeed, the fact of causation is incapable of mathematical proof, since no one can say with absolute certainty what would have occurred had the defendant acted otherwise. Since mathematical proof is impossible of ascertainment, proof of causation is based upon everyday experience of cause and result. "If as a matter of ordinary experience a particular act or omission might be

* Prosser and others also deem relevant in some situations, the issue of unforeseeable or unusual circumstances and that of external physical forces coming into operation subsequent to the defendants' conduct. Neither of those factors are present in this case.

*** Prosser, *op. cit.*, 242.

expected, under the circumstances, to produce a particular result, and that result in fact has followed, the conclusion may be permissible that the causal relationship exists.”* However, even where an expected result, in fact, occurs, the process of cause is basically a conjectural one, since circumstances may not inexorably repeat themselves in identical patterns. Nevertheless, in determining cause, previous observation that certain consequences have followed the type of conduct complained of may lead to the legal conclusion that the defendants’ conduct had something to do with the plaintiff’s injury, if such injury is akin to the consequence previously observed. “The true inquiry is whether the injury sustained was such as, according to common experience and the usual course of events, might reasonably be expected.”** Thus, “consequences which are normal, not extraordinary, not surprising in the light of ordinary experience”*** are deemed “natural” and “probable” consequences of unlawful conduct for which the defendants will be held liable. The plaintiff is not required to “eliminate by his proof all other possible causes” of his injury in order to justify the imposition of liability upon a defendant. What is required is that the plaintiff adduce proof of facts from which a causal connection between the defendants’ wrongful conduct and the plaintiff’s injury may be “reasonably inferred.”**** Plaintiff submits that in the instant case, his losses were “normal”, “not extraordinary” and “not surprising” consequences of the defendants’ fraudulent handling of his account. Not only were the plaintiff’s losses a consequence which can be “reasonably inferred” to have been caused by the defendants’ fraud, but as plaintiff will demonstrate, such losses were, in light of the defendants’ conduct, virtually inevitable.

* *Ibid.*

** *Derby v. Flitner*, 118 Mass. 131, 134 (1875).

*** *Prosser, op cit.*, 252.

**** *Cornbrooks v. Terminal Barber Shops, Inc.*, 282 N.Y. 217, 223 (1940).

b. The Plaintiff's Losses Were Normal And Unsurprising Consequences Of The Defendants' Fraudulent Handling Of The Plaintiff's Account.

"Customers dealing with a securities firm expect, and are entitled to receive, proper treatment and to be protected against fraud and other misconduct, and may properly rely on the firm to provide this protection."* It has been clearly recognized that "adequate investor protection depends to a great extent on the professional attitude and responsibility of the broker-dealer community."** "Indeed, the need for high standards in investment advice was pointedly brought home in a congressional report."*** As a result, standards have been developed in an attempt to ensure that a broker-dealer's customers are sold only those securities which the broker has a reasonable basis to recommend and which he has determined are suitable for the investor for whom they are purchased. "The concept of suitability expresses a homely truth about investing—investment decisions can be made only in light of the goals and needs of the person for whom they are made."**** In the instant case, not only did the defendants fail to make investment decisions to buy and sell securities in the light of the plaintiff's investment goals and needs, but they failed to make any effort to obtain the information necessary for a reasoned decision concerning the investment merits of the securities, themselves. Rather, the plaintiff's "account was handled by defendants solely for their own gain with no regard for plaintiff's well being."***** The use of plaintiff's account in furtherance of the defendants' fraudulent activities and the management of that account in a "gener-

* *Reynolds & Co.*, 39 SEC 902, 917 (1960).

** Mundheim, *Professional Responsibilities Of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445, 446.

*** Jacobs, *The Impact Of Securities Exchange Act Rule 10b-5 On Broker-Dealers*, 57 Corn. L. Rev. 869 (1972).

**** Mundheim, *op cit.* at 448.

***** Cobine, *Elements of Liability and Actual Damages in Rule 10b-5 Actions*, 1972 U. Ill. L.F. 651, 682.

ally" fraudulent way, rather than in conformity to accepted professional standards, clearly caused the plaintiff's loss.

1. Proper Investment Procedure.

The plaintiff testified and the court below found that the plaintiff not only sought capital appreciation but expected his investment adviser to "preserve the portfolio which Rolf had built up over the years through his own earnings and efforts and through the efforts of prior brokers. Indeed, since Rolf had no pension or retirement plan, his stocks represented his main security for his later years. (Tr. 19)" Since the plaintiff's goals called for the preservation of capital, they clearly required an investment approach which would seek to provide protection against ultimate loss. Such an approach should obviously be based upon thorough analysis, i.e., the study of important facts relating to the issue whose purchase or sale is contemplated in the light of established standards. Thus, in the case of a contemplated purchase of stock, the consideration of many factors may be important, including the nature of the business, its capitalization, its position in the industry, earnings and dividends, long term prospects, marketability, risk, the effect of the investment on the total portfolio already held, diversification, tax considerations and transaction costs.

Contemplated sales of securities involve a consideration of such factors as industry outlook, stock market trends, the extent of remaining potential in a growth stock, the decrease or cessation of dividends and the availability of a more advantageous investment to be substituted for the issue sold. The time for an investor to sell is when his securities are high and the proper management of a portfolio requires coordinated investment timing. Thus, stocks must be sold at the right time to avoid or limit losses and the determination of the right time requires a continual monitoring of the portfolio in the light of current developments.

Proper investment management requires honesty, skill, diligence, care, discrimination and patience. Experience has

shown that such management, combined with investment in sound issues, although not foolproof, should yield satisfactory overall results. In the instant case, however, the court need not speculate as to what skilled and professional management of the plaintiff's account would have achieved. For six years, the plaintiff's life savings were under the control of S. Logan Stirling, a partner of BEDCO, who was in charge of that firm's advisory department (JA 83, 584). Stirling, active in the research end of the business, analyzed and evaluated various stocks and prepared commentaries on them. Prior to his retention of Stirling as his investment adviser, the plaintiff met with him and discussed his investment objectives. Stirling, in turn, articulated his own investment policy (JA 83). That policy was reflected in the portfolio placed in the hands of Yamada and Stott which contained "23 listed issues of reputable quality" deemed appropriate by Stirling for the plaintiff.* The quality and performance of those stocks and the portfolio's six year record demonstrate that Stirling, in managing the plaintiff's account, had done so in conformity with standards which would ensure both preservation of capital and an adequate return.

During the six years of Stirling's skilled, professional management, the plaintiff's account grew threefold. The plaintiff was "fully satisfied" with the manner in which Stirling handled the account. Indeed, the court found that after Stirling's death, by retaining the combination of Stott and Yamada, plaintiff believed that "he was obtaining a Stirling-type operation." However, rather than a Stirling who conscientiously and skillfully nurtured plaintiff's account for six years, the court found that the plaintiff procured "a faithless investment adviser" and a broker who aided and

* Although the court noted that certain of those stocks were deemed "aggressive" by Yamada, that defendant defined aggressive investments as stock of "fairly active, traded companies" which were "listed on a national stock exchange." (JA 431).

abetted him, acting "with willful and reckless disregard" for the truth and "callous and knowing disregard" for his duties.

Plaintiff believes that the evidence in this case demonstrates that had he obtained the "operation" he sought and was led to believe he had procured, and thus, had his account been properly managed, the value of his portfolio would, at the least, have been maintained. Accordingly, the plaintiff contends, the starting point of any measurement of damages herein should be the value of his portfolio at the time Yamada and Stott assumed control of its management.

2. Investment Decisions Made in the Management of Plaintiff's Account Were Dictated By the Defendants' Need for Cash Arising From Their Fraudulent Activities.

Although the court found that both Yamada and Stott were involved in the purchase of stocks for the plaintiff's account, neither made any investment decision in the light of the plaintiff's investment goals or as a result of thorough analysis of facts pertaining to a security. Indeed, the court found that Yamada was not motivated by investment merit, but rather, used the plaintiff's large portfolio as a "tool", and that Stott "totally failed to investigate the stocks in the account" and "really didn't know anything about those stocks." Thus, neither Stott nor Yamada had any reasonable basis for recommending the purchase or sale of stocks on plaintiff's behalf and neither considered the suitability of any purchase for plaintiff's account. As the court below found, the defendant "Stott admitted that he never knew plaintiff's investment intent, and that he had no idea what type of investor this customer was when he recommended Yamada to Rolf".* Although plaintiff stated to Yamada, at

* Moreover, despite the fact that Stott admittedly never ascertained the plaintiff's investment goals, he, nevertheless, informed Yamada that, the doctor "was interested in aggressive investments." (JA 377,378).

their initial meeting, "at this stage of life, I want to be sure of my equity, I have to protect it," (JA 88) upon acquiring the account, Yamada gave not a single backward glance to the plaintiff's primary investment goal. Thus, as the court found, the defendants exploited the plaintiff's large account, making purchases and sales therein for their own ends, "trading the stocks through BEDCO with nary a thought as to their suitability or their legitimacy." The defendants' exploitation of the plaintiff's account took the form of the following fraudulent activities, all of which involved investment decisions made solely to benefit the defendants:

a. The Plaintiff's Portfolio Was Liquidated To Give Yamada Cash For His Manipulations And Stott Commissions.

The defendants effected a total liquidation of the Stirling portfolio primarily for reasons other than to further the plaintiff's investment objectives. It is clear from the testimony of both Yamada and Stott that in determining which of the plaintiff's securities should be sold or retained, the defendants never subjected such securities to careful scrutiny and evaluation in the light of their investment merit and the plaintiff's investment objectives.* Rather, those defendants engaged in wholesale selling in furtherance of their own purposes.

The evidence establishes that almost immediately upon obtaining control of the plaintiff's account, the defendants embarked upon a complete liquidation of the plaintiff's portfolio. Virtually all the plaintiff's stocks were in large part sold, "for reasons other than investment decisions." (JA 381). Yamada testified that the liquidation was de-

* For example, Asamera, an oil stock sold in the general liquidation by Yamada, who admittedly knew nothing of its merits, was subsequently bought back on Stott's recommendation. (JA 437).

signed "to raise cash" (JA 441) and "to give an immediate benefit to Mr. Stott of the commissions he derived from the existing portfolio." (JA 380). Thus, the plaintiff's entire portfolio was sold primarily to give Yamada ready cash for his manipulations and Stott the commissions he expected in return for recommending the plaintiff to Yamada.

The liquidation established the operational pattern which thereafter continued to control the defendants' handling of the plaintiff's account: Yamada, who the court found "was interested in [the] account only for its 'buying power'" for his own schemes, directed the activity in the account to accommodate and further his manipulative transactions. Stott, viewing the account as commission potential, directed his energies toward maximizing the commission income it produced. (JA 406-408). In advancing their own designs, the court found, Stott and Yamada used "very effective methods . . . to shuffle Rolf between the two of them."

b. Purchases Were Made By Yamada Of Stocks Of Whose Investment Merit He Was Ignorant On The Promise By Stott Of Inside Information.

When the account's buying power was not needed for manipulation, purchases were made for plaintiff upon the recommendation of Stott in stocks of companies engaged in the oil and gas business, an industry in which Yamada admittedly had no expertise. Despite the fact that Yamada believed himself to be "very weak in terms of oil stocks," and "just didn't know very much about it" (JA 434), Yamada purchased a number of oil stocks for plaintiff's portfolio. In making purchases in the oil and gas industry, Yamada "was guided by Stott's recommendations as to the quality of the shares and its appropriateness in Dr. Rolf's portfolio." (JA 563). However, as the court acknowledged in its opinion, "Stott testified flatly that he never knew what Rolf's investment objectives were." Thus, the defendant Yamada made a considerable investment in stocks

which he knew little about on the recommendation of Stott who knew nothing of the plaintiff's investment objectives and based the recommendation in large part upon the anticipated receipt of information from insiders. Yamada testified that he invested in oil and gas stocks only after being "urged" to do so by Stott because of his father's "involvement" in the oil and gas industry and Stott's assertion "that he was in a position to find out information," about that industry. (JA 384).

c. Purchases Were Made To Repay Yamada's Personal Debts.

Yamada made many of the purchases on plaintiff's behalf in order to pay personal debts. Thus, he testified that his purchase of Consolidated Oil and Gas was motivated by a need "to generate commission business to give to Lynch, Jones & Ryan" in order to repay that firm for the prior use of an office, secretarial services and telephone. (JA 386, 515). Yamada also made purchases in order to create commissions for Stott. For example, Yamada testified that although he had little knowledge of the investment merit of Natomas, at the time of his purchase of that stock for plaintiff, Yamada "was looking for certain liquid and volatile stocks to trade in so that [he] might generate some commission business and Natomas happened to fit the bill." JA 394, 395). Yamada felt the need to generate commissions for Stott since Yamada had, by certain purchases, "tied up" a large portion of the portfolio," thus, rendering a "significant amount" thereof non-liquid. (JA 395).

d. Almost All Of The Plaintiff's Portfolio Was Concentrated In Two Stocks, One A Fraudulent Venture, The Other A Low Quality, Speculative And Unsuitable Security.

A substantial portion of the plaintiff's money was placed in two investments which rendered the portfolio virtually illiquid. At the time the defendants commenced manage-

ment of the plaintiff's margin account, the court found that it "was worth \$1,423,000 net". The court further found that eight months thereafter, "the value of Rolf's securities had dropped by over \$700,000." During the intervening period, by the investment of approximately \$400,000 in stock, calls and warrants bonds of Delanair, Inc., and almost a quarter of a million dollars in Monarch Industries, Inc., "close to \$600,000 of the portfolio was tied up, so to speak", thus, making "a significant amount of the portfolio illiquid." (JA 395).

The Delanair issue was described by plaintiff's expert witness as "lowest of the low". The court specifically found that "Yamada's actions with respect to Delanair operated as a fraud upon the plaintiff" and that the plaintiff "clearly" proved that he was directly defrauded through the Delanair transaction. The plaintiff lost \$400,000 in Delanair.*

Monarch was, in the language of the court, "an obscure issue", described by plaintiff's expert as a "low quality" stock. The court found that Rolf lost \$159,000** on the Monarch transaction when the stock was sold at a time when Yamada "was trying to keep sort of a balloon from collapsing" (JA 456). Thus, the defendants not only invested plaintiff's money in unsuitable securities, but increased his risk of loss by heavily concentrating his investment therein.

e. Stocks Were Purchased In Direct Furtherance Of Yamada's Manipulative Schemes.

Numerous stocks were purchased by Yamada in securities which the court found "Yamada knew were being

* He subsequently recovered \$175,000 of those losses in a lawsuit against defendants other than those herein.

** That loss was actually larger, since the proceeds received from Monarch were invested in SEIJO. The plaintiff lost his entire investment of \$98,000 in SEIJO.

manipulated, either before or shortly after the dates of purchase:

“Visual Sciences, Inc.
Health Evaluation Systems
Hair Extension Centers
GPI Enterprises, Inc.
MH Studios
Tranquilaire Mental Health
Creative Polymer Products.”

The court described the manipulated stocks as “new issues,” and “highly speculative” securities about which no “public information” was available. As the court noted “[i]n his testimony at trial, Yamada described the functional aspects” of the manipulations involved in this case:

“Generally, Yamada along with a group of other money managers and underwriters would seek to obtain control of new, thinly-traded, over-the-counter securities. Once the group had purchased the great majority of the outstanding shares, they would begin to trade the stock up, by selling to each other at gradually higher and higher prices. Thus, the market price would be manipulated upwards, and other investors would become interested in the stock, thinking that the price rise was due to legitimate factors. At the end of the manipulation, the conspirators would sell out, leaving an unsuspecting group of investors with a large amount of artificially-inflated stock. Often, once the manipulators left the scene, the price of the stock would plummet, as was the case with Health Evaluation Systems (Tr. 624-25).”

It was clear from Yamada's testimony that the purchase of manipulated stocks required intricate timing. Thus, he stated, it was more advantageous to get in “early, when the stock was low” (JA 579) and get out before the stock began its precipitous fall. Inability to get in and out of the manipulated stocks at the appropriate time enhanced the risk of loss. (JA 578). Thus, investment in manipulated

stocks required immediately available cash in order to properly effect and exploit a manipulation and other stocks had to be sold when cash was needed.

f. Stocks Were Purchased On The Orders Of Yamada's Partner

Stocks were purchased for plaintiff by Yamada on the sole basis of investment decisions made by Yamada's partner, John Galanis. Yamada testified that although Galanis "did not have actual control" over plaintiff's account, Yamada would obey Galanis' instructions to buy certain stocks without "debate," for that account. (JA 472). For example, MH Studios, which Yamada testified "was an off-beat purchase . . . for a substantial sum of money," was bought for plaintiff by Yamada "more or less on Mr. Galanis' [sic] sayso." (JA 469)

From the above, it is clear that investment decisions to buy or sell stocks for the plaintiff's portfolio were not made on the basis of research and analysis. There is no evidence that even a single stock was purchased as the result of careful evaluation of its investment merit, in the light of the plaintiff's investment goals. Rather all purchases were made in the furtherance of fraudulent activities. Investment was made not in quality issues, but in stocks variously described by the court as "unlisted," "restricted," "lowest of the low," "obscure," "highly speculative," "new issues," "high-fliers," "manipulated," and "junk." That plaintiff lost virtually all his savings as a result of investment in such securities is not "surprising" or "unexpected". One authority has stated with respect to buying stock in "new or virtually new ventures," that "[t]he odds are so strongly against the man who buys into these new flotations that he might as well throw three-quarters of the money out the window and keep the rest in the bank."* If the odds are such for issues which are merely new, they are undoubtedly even worse for "junk."

* Graham, Dodd, Cottle, *Security Analysis*, (1962) 722.

Although the court noted that there was some investment in issues which were not unsuitable for plaintiff, it is clear that those issues were purchased solely to generate commissions and pay debts during a period when cash was not needed for manipulation. Those stocks were quickly liquidated when cash was required. Thus, the "functional aspects" of Yamada's fraudulent transactions precluded the exercise of even minimal investment discretion with respect to the purchase and sale for plaintiff of suitable securities, as such purchases and sales could not and were not timed to take advantage of such investment factors as new developments, market trends and growth potential but, rather, to accommodate the defendants' cash needs. Under such circumstances, even though the stocks were of a suitable nature, since potential growth could never be realized nor market trends heeded, the plaintiff's losses therein were virtually pre-ordained.

Plaintiff submits, that in the light of ordinary experience, all his losses were unextraordinary foreseeable consequences of the ~~plaintiff's~~^{defendants'} fraudulent handling of his account as above described, and, thus, under relevant tort concepts, the defendants' conduct was the proximate cause of the damage plaintiff sustained. Such a conclusion is amply supported by commentators and judicial authority in the field of torts. Moreover, evidence which meets the criteria of causality set forth in negligence actions, plaintiff contends, more than fulfills such standards in a case where actionable fraud has been found. That "judgments of causation are essentially relevative and purposive" has clearly been recognized. Thus Justice Cardozo, after noting the infinity of antecedents that come together in any event we seek to explain, observes:

"From this complex web the law picks out now this cause and now that one. Thus the same event may have one jural cause when it is considered as giving rise to a cause of action upon contract, and another when it is considered as giving rise to a cause of action for a

tort. The law accepts or rejects one or another as it measures its own ends and the social benefits or evils of rejection or acceptance.”*

In the instant case, acceptance of the defendants’ “gross” fraud as the cause of all the plaintiff’s loss is not only factually and legally sound, but would help to achieve an equitable result and, as discussed in Point II below, promote desirable social ends.

3. Conceding, Arguendo, That The Plaintiff’s Damage Was, As The Court Found, Suffered As A Result Of The Defendants’ Fraud, Poor Investment Decisions And A Bear Market, The Damages Should Have Been Apportioned Between Them.

There is no uncertainty in this case as to the fact of the plaintiff’s damage, the exact amount thereof or the fact that the defendants by their fraud caused at least a portion of it. Assuming, arguendo, that the court below was correct in holding that causes other than the defendants’ fraud also contributed to the plaintiff’s loss, the court was, nevertheless, in error in refusing to apportion the overall damage. Where the entire damage sustained by a plaintiff is the result of two or more causes, for only one of which the defendant is liable, the court should apportion the damage between the contributing causes.

Courts have been loath to refuse relief to a plaintiff because of difficulty in establishing the exact proportion of damage caused by a defendant’s wrongful act and it has been generally held that “difficulty in apportioning the amount of such damage is no reason to deny plaintiff a recovery.”** Prosser states with respect to apportionment:

“Once it is determined that the defendant’s conduct has been a cause of some damage suffered by the

* Cardozo, *Paradoxes of Legal Science* 83 (1928).

** *Nordone v. Mondo*, 269 App. Div. 896, 56 N.Y.S.2d 606 (4th Dept. 1945).

plaintiff, a further question may arise as to the portion of the total damage sustained which may properly be assigned to the defendant, as distinguished from other causes. The question is primarily not one of the fact of causation, but of the feasibility and practical convenience of splitting up the total harm into separate parts which may be attributed to each of two or more causes. Where a logical basis can be found for some rough practical apportionment, which limits a defendant's liability to that part of the harm which he has in fact caused, it may be expected that the division will be made. Where no such basis can be found, and any division must be purely arbitrary, there is no practical course except to hold the defendant for the entire loss, notwithstanding the fact that other causes have contributed to it

* * *

In general, it may be said that entire liability will be imposed only where there is no reasonable alternative. Each case must turn upon its own particular facts.”*

If apportionment cannot be made, “entire liability will be imposed both where some of the causes are innocent . . . and where two or more of the causes are culpable.” Where “results, by their nature” are capable of apportionment, some rational and sound basis should be found to do so. Apportionment is proper “where some part of the damage may logically and conveniently be assigned to an innocent cause.”**

The law is generous in the license it accords to triers of the facts in seeking to segregate damages. Prosser states:

“The courts necessarily have been very liberal in permitting the jury to award damages where the uncer-

* *Op. cit.*, 313-314.

** Prosser, *op. cit.* 313, 316, 318.

tainty as to their extent arises from the nature of the wrong itself, for which the defendant, and not the plaintiff, is responsible. The requirements of proof usually have been somewhat relaxed in such cases, and it has been said that no very exact evidence will be required, and that general evidence as to the proportion in which the causes contributed to the result will be sufficient to support a verdict. Cases are few in which recovery has actually been denied for lack of such proof.”*

In the instant case, the plaintiff submits, the court could easily have apportioned damages between those causes it deemed responsible for the plaintiff's damage. Thus, plaintiff should have been compensated for all losses in unsuitable stocks purchased for plaintiff's account by Yamada, i.e., those speculative securities of low quality or lowest of the low. Such stocks are set forth below:

Delanair, Inc.
 Funeral Homes of America
 Monarch Industries
 Synchronex Corp.
 Holobeam, Inc.
 Hair Extension Centers
 International Health Science

Losses in the above stocks total approximately \$700,000. Since such stocks include Delanair, a lowest of the low issue whose purchase the court deemed a “gross fraud,” \$175,000 should be credited to the defendants since that amount was

* *Id.* at 319. Where the usual requirements of certainty in proof of causation have been deemed too severe to meet the ends of justice, some courts have also relaxed the stringency of the proof required by creating presumptions or imposing on the defendant the burden of proving that his fraud was not the cause of the plaintiff's loss. See, e.g. *Tope v. King County*, 189 Wash. 463, 65 P.2d 1283 (1937).

recovered by plaintiff in a lawsuit against others involved in that transaction. Thus, the above loss should be reduced to approximately \$525,000.

Plaintiff should also have been compensated for all stocks selected for his portfolio by Stott, since plaintiff made clear from the outset, that he did not wish Stott to direct transactions in his account, but merely to oversee Yamada's management of it. (JA 211-212) As the court below found, however, "[t]he conduct of the defendant Stott, resulted in his direct participation in the management of the account." The evidence established that stocks selected by Stott were purchased by Yamada without investigation, though he had little or no knowledge of their investment merit, in order to give Stott the commissions he demanded for referral of the account and for his silence with respect to the "junk" Yamada was purchasing for it. (JA 406-408). Stocks purchased on Stott's recommendation as found by the Court, are as follows:

"Simplex Wire & Cable Co.
 Teradyne, Inc.
 Standard Oil, N.J.
 Reading & Bates Offshore
 Intertherm, Inc.
 Food Fair Properties
 International Funeral
 Natomas Corp.
 Asamera Oil Corp.
 Carter Wallace, Inc.
 West Coast Production
 Equity Funding Corp."

Losses in the above stocks total \$162,000.

By awarding plaintiff the aggregate losses set forth above of approximately \$854,000, the court would clearly have eliminated any possibility of losses due to poor investment decisions, since no losses whatsoever on the liquida-

tion of the portfolio are included. However, the plaintiff reasserts his belief that the liquidation losses as well as those occasioned by the defendants' purchases were caused not by poor investment decisions, but by the fraudulent nature of the defendants' handling of plaintiff's account.*

In addition, in awarding damages for trading losses, the court could have corrected for any loss it believed attributable to a bear market. In *Feit v. Leasco Data Processing Equipment Corp.*,** where the court found a violation of Section 11 of the Securities Act of 1933, the court took judicial notice of the general decline in stock market prices during the period in question. The court concluded that some portion of the decline in Leasco stock would have resulted, absent the defendants' alleged misrepresentation, from the forces causing the general market depression. Accordingly, the court adjusted damages to account for the general decline, selecting Standard and Poor's Daily Stock Price Index as a gauge of market performance. The court then employed a ratio, based upon the Index, in order to measure the amount of damage resulting from general market conditions.

Certainly, as in *Leasco* the court in this case could easily have employed some discount factor to compensate for the bear market it found to have been responsible in part for

* The amount of damages need not be proven with absolute certainty. "Damages for tort injuries are rarely ascertainable in any accurate sense—they are rather matters of reasonable proportions, considering all of the circumstances of the case." *Falstaff Brewing Corp. v. Iowa Fruit & Produce Co.*, 112 F.2d 101, 105 (8th Cir. 1940). "[W]hen damages are at some unascertainable amount below an upper limit and when the uncertainty arises from the defendant's wrong, the upper limit will be taken as the proper amount." *Gratz v. Claughton*, 187 F.2d 46, 51, 52 (2d Cir.), cert. denied, 341 U.S. 920 (1951)

** 332 F. Supp. 544 (E.D.N.Y. 1971).

the plaintiff's losses.* Plaintiff submits that it is both illogical and contrary to the purposes of the Federal Securities Laws to deny a plaintiff any recovery whatsoever of trading losses which were the result of the defendants' fraud, merely because such losses were sustained during a period of market decline. The awarding of damages during a bull market and the denial of such an award in periods of market decline would have only the effect of causing those who defraud to limit their activities to periods of falling prices, truly not the type of deterrent effect the Securities Laws were designed to create. Accordingly, in view of its finding that the defendants' conduct caused some of the plaintiff's loss, the court's failure to apportion damages herein was erroneous and unjust.

II

THE COURT APPLIED AN ERRONEOUS AND UNFAIR MEASURE OF DAMAGES.

Although the "[c]ourts have adopted many 'rules' to aid in measuring the size of money recoveries," such rules rest upon the basic principle that "damages should be computed so that the dollars awarded will be an adequate *compensation* for the *loss* which was suffered by the injured party."***

Indeed, compensation has been almost invariably deemed "a fundamental principle of damages."**** In a tort action, "[a]s a general rule, one injured by the commission of

* It should be noted that in *Chasins, supra*, the court did not correct for market trends, even though the plaintiff's loss was incurred "by a sale" at or near the bottom of the devastating bear market that held sway during the first six months of 1962. Note, 71 Col. L. Rev. 495, 500 (1971).

** Nordstrom, *Damages as Compensation For Loss*, 5 N.C. Cent. L.J. 15 (1974). (Emphasis in original).

*** *J. B. Preston Co. v. Funkhouser*, 261 N.Y. 140 *aff'd sub nom. Funkhouser v. J. B. Preston Co.*, 290 U.S. 163 (1933).

fraud is entitled to recover such damages" as will "place him in the same position that he would have occupied had he not been defrauded."* Thus, in the instant case, since a private 10b action sounds in tort, plaintiff is entitled to be returned to the financial position he would have been in had he not been the victim of the defendants' fraud. However, the measure of damages adopted by the court below did not achieve, or even approach that result. Accordingly, plaintiff submits, the court's damage award was both erroneous and unfair.

Although in framing a rule for the determination of a proper award of damages in 10b-5 litigation, courts start with the proposition that their action should restore the plaintiff to his former status, no set measure of damages has been established to be applied in all cases. Moreover, since civil liability is implied under Rule 10b-5, the rule, itself, provides no guide.** Thus, the plaintiff in a 10b-5 action has a choice of remedies which have been established in other contexts and the actual form of recovery will necessarily vary with the particular facts and circumstances of each particular case. Accordingly, the courts have taken an ad hoc approach in finding damages appropriate to the facts of the case, and have usually applied the damage measure which would most nearly make the injured investor whole.

A. Analysis of Damage Measures Generally Used by the Courts in 10b Litigation Demonstrates That Rescissory Damages are Appropriate Herein.

The measure of damages employed by the courts in 10b-5 suits has included:

1. The out-of-pocket measure, i.e., the difference in value between what the plaintiff paid for securities

* *Fudge v. Physicians Insurance Co.*, 125 F. Supp. 653, 657 (W.D.S.C. 1954).

** Section 28(a) of the Exchange Act, does, however, prohibit a recovery in excess of a plaintiff's "actual damages on account of the act complained of."

and what he received. This has been the most consistently applied damage rule in 10¹-5 litigation.

2. The loss of the bargain measure of damages, i.e., generally, the difference between the actual value of securities purchased and their represented value. The measure may also include the defendant's profit and seeks to award what the plaintiff might have gained, rather than what he lost. Although the loss-of-the-bargain measure is not widely applied, it has been suggested that this measure is particularly suited to a case involving the mismanagement of a securities account, since the award to plaintiff of profits which a properly managed account would have yielded is most apt to make a plaintiff whole.

3. Quasi-contractual measure of damages, i.e., the amount which the defendant broker-dealer earned as commissions and other fees in connection with the fraudulent transactions. This measure was the one adopted by the court below. Although the award of quasi-contractual damages is the easiest one to make, since the calculation involved is a very simple one, the award is unfair and unjust, as the amount of the dealer's earnings "bears no rational relationship to the amount of harm done to the customer."*

4. Rescissory Damages, i.e., rescission, restitution and equivalent damages. Rescissory damages seek to place the plaintiff in the same position he occupied prior to the fraudulent conduct. Plaintiff contends that the rescissory measure of damages is the one most appropriate to the facts of this case, and is the one which the court below should have adopted.

Rescissory damages seek to restore to a plaintiff the monetary equivalent of the value of his securities prior to

* Note, *Churning By Securities Dealers*, 80 Harv. L. Rev. 867, 884 (1967).

the fraud perpetrated by the defendant. Under the rescissory measure of damages, the plaintiff is awarded actual trading losses in fraudulent transactions. Where the overall fraud is considered a "unified offense" involving "an extended course of operations,"* and none of the transactions are deemed proper, this measure is computed as the amount of the customer's investment prior to the fraud and the amount returned to him, or, if he began with a portfolio of securities, as the value of the portfolio at the beginning less the value at the end of the period in which the fraud occurred.

Rescissory damages has been deemed a much preferable measure of damages to quasi-contractual recovery in that the former's "specific objective is to compensate the plaintiff."** The measure is also consistent with general damage principles, since it awards the plaintiff actual losses sustained. It is, of course, imprecise in the sense that it awards damages as if no trading had taken place and, thus, does not include the possibility that loss might have occurred absent fraud. However, as plaintiff has already discussed, the evidence in this case established that proper management of his account over a six year period tripled his investment. Moreover, in any situation, "[t]he fact determinor can never be certain that the loss complained of would not have occurred even if the defendant had performed the duty which he owed the plaintiff." As one commentator has observed:

"When a court in a contract action awards damages measured by the value of gains prevented, there is the possibility that other events may have prevented the plaintiff from realizing the gains for which he is now suing. Had the defendant performed his promise, the

* Note, *Churning By Securities Dealers*, *supra*, 884. Rescissory recovery is called "out-of-pocket" recovery, a term which usually refers to a different measure.

** *Ibid.*

plaintiff would have received the promised consideration. Thereafter, the plaintiff may have mismanaged what he received or may have entered into other arrangements (which he did not enter into because he did not receive the defendant's performance) which in fact would have prevented the gains which he is now awarded. When a court in a personal injury case awards damages measured by the value of plaintiff's lost income, there is a possibility that, had the tort not occurred, the plaintiff may have died or lost his job for reasons wholly unconnected with the tort—or the plaintiff may have unexpectedly been able to accumulate a much larger sum of money than his lost income, simply because he was not lying in a hospital bed. Similar possibilities exist in an action for negligent destruction or conversion of property. Had the tort not occurred, the plaintiff would have had full use of the property and may have lost it or destroyed it through his own negligence or may have been able to use it to an unexpected advantage. These are all *possibilities*. The court can never be *certain* that it is compensating for losses caused by the defendant's wrongful activity. The most that the compensation principle can mean is that the law attempts to compensate for *probable* losses.”*

Thus, where it has been shown that the defendants' conduct was the cause of actual injury to the plaintiff, the court will not speculate as to the possibility that, absent such conduct, the damage might still have occurred,** and, accordingly, the award of rescissory damages is proper in cases such as this.

* Nordstrom, *op cit*, at 22-23 (Emphasis in original)

** See also, *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965), where the same reasoning is used with respect to the defendant's profits.

In *Twomey v. Mitchum, Jones & Templeton, Inc.*,* where the court awarded plaintiff rescissory damages in the form of her trading losses plus the estimated amount the account would have earned had it been properly managed, the defendants objected to the "allowance of reconstructed earnings" as "entirely conjectural." The court rejected the defendants' contention on the ground that it overlooked the fact that the defendant's advice had resulted in the loss. The court stated that "[t]he fact that [the plaintiff] might have done worse if left to her own devices [could] not justify the defendants' improper handling of her account."

Rescissory damages have been awarded by the courts in numerous securities cases where, as here, other measures of damages would not adequately compensate the plaintiff for his losses. Thus, in *Speed v. Transamerica Corp.*,** where the defendants purchased the stock of plaintiff and the class without disclosing their intention to liquidate the company's inventory, the court carried out a "reconstructed liquidation" as if the class had not sold their shares, in order to award them the amount they would have received in the actual liquidation, had they still been shareholders.

In *Esplin v. Hirschi*,*** the court awarded plaintiffs who "incurred a loss as a result of the fraudulent practices of the defendants in the sale of securities," damages which were measured by "the difference between the price paid for the securities with interest from the date of purchase, and the value of the securities determined as of the time of the discovery of the fraud."

* 262 Cal. App.2d 690, 69 Cal. Rptr. 222 (1968). The court called the measure used the "out-of-pocket rule".

** 386 F. Supp. 176 (D. Del. 1955) *mod. on other grounds*, 235 F.2d 369 (3rd Cir. 1956).

*** 402 F.2d 94, 104 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969).

This Circuit in *Chasins v. Smith Barney & Co.*,* applied a rescissory measure of damages, awarding plaintiff the difference between the purchase price and resale price of securities purchased by him. In that case, where the broker did not disclose its market making role, the court deemed the rescissory measure of damages appropriate, since, as it stated, "the evil [was] not the price at which Chasins bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of Smith, Barney's interest." Thus, the out-of-pocket measure of damages would not have recompensed the plaintiff for his loss.**

In the instant case, as in *Chasins*, the "evil" is not the prices at which the plaintiffs' stocks were purchased, or sold, but rather the quality of the stocks purchased, and as discussed above, the manner in which they were purchased and sold. Not only were unsuitable, indeed "junk" securities, purchased for plaintiff in an account managed solely for the defendants' profit, but the plaintiff was assured and reassured by the defendants' false representations that the stocks purchased for him were suitable and that virtually no risk attended the transactions made on his behalf. Had the defendants revealed to plaintiff from the outset that the operation was, in fact, rife with fraud, none of the losses sustained by him would have been incurred. Accordingly, he submits, the measure of damages employed in *Chasins* is the one most appropriate to his case and the one which should have been applied by the court below.

Support was also given the "rescission" theory of damages in *Gordon v. Burr*,*** where the court granted rescissory relief to the plaintiff who invested in a new offering of

* *Supra*.

** See also, *Sarlie v. E. L. Bruce Co.*, 265 F. Supp. 371 (S.D.N.Y. 1967) where a similar measure was employed.

*** 506 F.2d 1080 (2d Cir. 1974).

a corporation's stock based upon material misrepresentations made by his seller and the broker who effected the sale. In a fraud action, the court held, citing a long history of support under New York law,* privity is not a prerequisite to the availability of the rescission remedy to a defrauded plaintiff.

"To avoid unjust enrichment, general equitable principles indicate the preferability of the purchaser pursuing first the seller, rather than his partner in the fraud. However, as between the innocent purchaser and the wrongdoer who, though not a privy to the fraudulent contract, nonetheless induced the victim to make the purchase, equity requires the wrongdoer to restore the victim to the status quo."

A rescissory measure of damages was upheld against accountants in the recent case of *Herzfeld v. Larenthol, Krekstein, Horwath & Horwath*.** In that case, a false audited report was deemed a "substantial factor" in the plaintiff's decision to "go through" with a purchase of securities. The court awarded plaintiff his losses on the purchase, i.e., the purchase price, less the worth of the securities at the time of trial. Although the court called it "out-of-pocket" loss,** the damage award which restored plaintiff to his original status was clearly rescissory in nature.

An award of rescissory damages was suggested recently by this Court in *Abrahamson v. Fleschner***** in guidelines set forth on remand for trial. In that case, where general partners failed to disclose the existence and extent of the partnership's investment in unregistered securities, limited partners were deemed entitled to that part of net losses

* *Id.* at 1083.

** 540 F.2d 27 (2d Cir. 1976) *aff'g in part and rev'g in part on other grounds*, 378 F. Supp. 132 (S.D.N.Y. 1974).

*** 378 F. Supp. at 132.

**** CCH Fed. Sec. L. Rep. ¶ 95,889 (2d Cir. Feb. 25, 1977).

on unregistered securities incurred after the defendants' representations became fraudulent which stemmed from the portion of investments inconsistent with defendants' representations.

As the above cases demonstrate, where the plaintiff's loss does not stem from the unfair price at which securities were purchased or sold by him, but rather, from the nature of the purchase, itself, the rescissory measure of damages is the proper one. In cases such as this, where the plaintiff's purchase or sale would not have been made, but for the defendants' fraud, the plaintiff is entitled to be placed in the position he would have occupied had such fraud not taken place. Thus, the plaintiff herein is entitled to recoup his trading losses of approximately \$1,120,000, in addition to commissions and interest previously awarded by the trial court.

B. In Awarding Damages, The Court Below Erroneously Interpreted Relevant Precedent And Failed To Consider The Legislative Purpose.

The court below declined to follow two state court cases* awarding net trading losses in unsuitability cases because it was unaware of any federal court which had ever applied that damage theory and because "both *Twomey* and *Pierce*" involved churning as well as unsuitability, and the court had found no churning to have occurred in this case.** Hav-

* *Twomey v. Mitchum, Jones & Templeton, Inc., supra*, and *Pierce v. Richard Ellis & Co.*, 62 Misc. 2d 771, 310 N.Y.S. 2d 266 (Civil Ct. N.Y. Cty., 1970).

** The court also erroneously stated that the court in *Lehman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, N.Y.S. 2d (Sup. Ct. NY. Cty., Feb. 24, 1976), failed to follow *Pierce*. The court in *Lehman* deemed the award of all trading losses excessive. However, it approved the award of such losses in the amount of \$328,000 and punitive damages of \$100,000. The case certainly lends no support to the quasi-contractual measure.

ing declined to follow *Twomey* and *Pierce* because in addition to unsuitability, those cases compensated the plaintiff for churning, in an exercise of supreme illogic, the court below chose to follow *Hecht v. Harris Upham & Co.*,* and *Stevens v. Abbott Proctor & Paine*,** in which damages were awarded *only* for churning. The court in *Hecht* had found that the plaintiff was precluded from claiming unsuitability losses on the ground of "waiver and estoppel" and in *Stevens*, only churning was alleged. Thus, in this unsuitability and misrepresentation case, the court below adopted the measure of damages deemed appropriate by the courts only to a case of churning.

The recovery of commissions, alone, in the case of churning can perhaps, be justified in theory. If the defendant broker purchased for the plaintiff stocks of identical worth and potential as those which were sold and no loss occurred as a result of ill-timed purchases and sales, the plaintiff would be damaged only to the extent of the commissions improperly generated. Thus, the award of commissions, alone, assumes no breach of the suitability rule and no damage resulting from purchases and sales which were ill-timed, due to fraud. As a result of the unrealistic assumptions underlying its application, the quasi-contractual measure of damages has been roundly criticized, even in churning cases. One commentator has stated that the approach to churning damages taken by the courts in *Hecht* and *Stevens* is "unsatisfactory because it fails to make plaintiff whole"*** since a very real possibility exists that defendants cause trading loss "in their zeal to increase commissions." Thus, "[i]n the situation where a broker's motive is merely to trade for commissions, it is quite reasonable to believe that the appropriateness of the security for the client's account would be a secondary consideration in the mind of the

* 430 F.2d 1202 (9th Cir. 1970).

** 288 F. Supp. 836 (E.D. Va. 1968).

*** Cobine, *op. cit* at 681.

broker, especially since he knows he will be trading that security to produce another commission in a very short time. In *Hecht*, the district court precluded itself from awarding out-of-pocket damages because of its finding of waiver, laches, and estoppel. If it were not for this finding, it appears likely that the court would have awarded damages on the basis of out-of-pocket losses of the plaintiff.”*

Another commentator has deemed the quasi-contractual theory of recovery “inadequate” since it ignores “the compensatory purpose of damage actions for churning.”**

Thus, application of the quasi-contractual theory of damages applied by the court below has been criticized even in churning cases, since unsuitability may often accompany churning. Clearly, therefore, in a case such as this, where the court found the defendants to have effected the complete transformation of plaintiff’s account from one containing sound listed securities, into one composed of unsuitable junk and to have misrepresented to plaintiff the nature and consequences of their conduct, the application of a churning measure of damages has no conceivable justification and is both irrational and unjust.

Moreover, the damage measure adopted by the court below which failed to award even compensatory damages, in no way recognized “the delicate fiduciary nature of an investment advisory relationship”*** or the deterrent effect which the securities laws were designed to achieve. It has become, by now, axiomatic that the Exchange Act, as remedial legislation, should be construed broadly, so as to

* *Id.*, at 682, fn. 41, 42.

** *Churning by Securities Dealers*, *supra*, at 883, 884. Less has also “questioned” the limitation of recovery to the commissions paid. 6 Loss, Securities Regulation (1969 Supp.) 3679.

*** *SEC v. Capital Gains Research Bureau*, 375 U.S. 181, 191 (1963).

effect the Congressional intent.* In *J. I. Case & Co. v. Borak*,** the Supreme Court granted a broad mandate to the district courts "to provide such remedies as are necessary to make effective the congressional purpose" when the Exchange Act has been violated, quoting with approval from *Bell v. Hood*.***

"And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done."

In fashioning an appropriate remedy, the courts have used as their guide the need to compensate the victim for his losses while stripping the wrongdoer of his profits.**** In the instant case, the court's award of damages, far from effecting the Congressional purpose, could actually provide an incentive for fraud. A measure of damages which requires only that broker-dealers return commissions earned on fraudulent transactions such as those herein has no deterrent effect, since there is little chance of a defendant's being discovered in every fraudulent act. In balancing the profits to be made against the likelihood of apprehension and the penalties of discovery, the securities law violator would undoubtedly consider the forfeiture of commissions no weighty dissuader from fraud.

Plaintiff concludes, therefore, that the award of rescissory damages is clearly the proper one in this case, since it

* E.g., *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976).

** 377 U.S. 426, 433 (1964).

*** 327 U.S. 678, 684 (1946).

**** *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972); *Janigan v. Taylor*, *supra*.

would both fairly compensate the plaintiff for his loss and serve some deterrent function as well.*

III

PLAINTIFF IS ENTITLED TO AN AWARD OF PREJUDGMENT INTEREST.

Although the award of prejudgment interest is a matter of judicial discretion**, such discretion must be exercised in an articulate and reasoned manner. The reasoned determination required, however, was clearly not made herein. Indeed, the instant case presents a situation remarkably similar to *Wessel v. Buhler*,*** in which the Ninth Circuit noted:

"Whether interest will be awarded is a question of fairness, lying within the court's sound discretion, to be answered by balancing the equities. (*Blau v. Lehman* (1962) 368 U.S. 403, 414, 82 S. Ct. 451, 7 L.Ed.2d 403; *Norte & Co. v. Huffines*, (2d Cir. 1969) 416 F.2d 1189, 1191-1192, cert. denied *sub nom.* *Muscat v. Norte & Co.* (1970) 397 U.S. 989, 90 S. Ct. 1121, 25 L.Ed.2d 396; *Hecht v. Harris, Upham & Co.* (N.D. Cal. 1968) 283 F. Supp. 417, 444; *Ross v. Licht*, (S.D.N.Y. 1967) 263 F. Supp. 395, 411-412). Here, the district court denied appellants' motion for interest without any explanation. Due to the flagrant use of false statements in the March 1963 Prospectus, for which Buhler was responsible, we cannot state that considerations of fairness would deny an award of prejudgment interest."

* As this court held in *Globus v. Law Research Serv. Inc.*, 481 F.2d 1276 (2d Cir. 1969), cert. denied 397 U.S. 913 (1970), the deterrence of punitive damages, clearly appropriate in this case in light of the court's finding of perjury on the part of the defendant Stott, is not available in 10b actions. At the least, plaintiff contends he should have received compensatory damages.

** *Blau v. Lehman*, 368 U.S. 403, 414 (1962).

*** 437 F.2d 279, 284 (9th Cir. 1971).

The fraud herein, found by the trial court on the basis of facts presented to it, was equally reprehensible to that in *Wessel*. Yet, without any discussion, the court denied prejudgment interest, merely citing the case of *Stevens v. Abbott Proctor & Paine*,* in which the court, without explanation or further discussion held that "interest on said judgment shall run from this date."

As equitable considerations govern the award of prejudgment interest, such interest is generally awarded in cases such as this involving fraud or a breach of fiduciary duty.** In *Occidental*, *supra*, the Fourth Circuit observed that when fraud is found in securities cases, prejudgment interest is "much more likely to occur" than in cases in which no fraud is present. Thus, the court's failure to explain in any way its denial of prejudgment interest indicates that such denial was a breach of discretion.

Moreover, although the award of such interest involves considerations of fairness, the fundamental basis of prejudgment interest lies in its origin as a form of compensation.*** As the Supreme Court stated: "Compensation is a fundamental principle of damages whether the action is in contract or in tort . . . [W]hen necessary in order to arrive at fair compensation, the court in the exercise of a sound discretion may include interest or its equivalent as an element of damages."**** Thus, interest is awarded in a

* *Supra*.

** E.g. *Occidental Life Insurance Co. v. Pat Ryan & Associates, Inc.*, 496 F.2d 1255, 1268-69 (4th Cir.), *cert. denied* 419 U.S. 1023 (1974); *Norte & Co. v. Huffines*, 416 F.2d 1189 (2d Cir. 1969) *cert. denied sub nom. Muscat v. Norte & Co.*, 397 U.S. 989 (1970); *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975), *aff'd*, 542 F.2d 915 (4th Cir. 1976); *Cant v. A. G. Becker & Co., Inc.*, 384 F. Supp. 814 (N.D. Ill. 1974).

*** *Norte & Co. v. Huffines*, *supra*.

**** *Miller v. Robertson*, 266 U.S. 243, 257, 258 (1924).

case in which actual wrongdoing, as opposed to a mere technical statutory violation, has occurred to fully compensate the injured party for the loss of the use of his funds and to prevent a wrongdoer from speculating with the plaintiff's property.*

In furtherance of the basic compensatory principles upon which the award of interest stands, one court recently took account of the present period of accelerated inflation:

"A further consideration in weighing the issue of prejudgment interest in this case would appear to be the decline in the purchase value of the dollar since June 3, 1969 as the result of inflation of which this Court believes it can and should appropriately take judicial note."

Plaintiff submits that based on the foregoing principles of equitable compensation and "the egregious violations" which the trial court found to have occurred herein, the denial of prejudgment interest in the present case is not only unexplained, but inexplicable.

CONCLUSION

"The constant tendency of the courts is to find some way in which damages can be awarded where a wrong has been done. Difficulty of ascertainment is no longer confused

* *Fox v. Kane-Miller Corp.*, *supra*, 398 F. Supp. at 651. In the instant case, the defendants' exploitation of the plaintiff's portfolio certainly approaches an unauthorized use tantamount to conversion. In conversion, "[u]sually, the measure of damages is the value of the goods at the time of conversion, plus interest." Hill, *A New Found Hali-day* [sic]: *The Conversion of Intangible Property—Re-Examination of the Action of Trover and Tort of Conversion*, 1972 Utah L. Rev. 511, 524.

with right of recovery.”* Rules of damage attempt “to reflect basic principles which American courts believe will best promote ‘fairness’ and ‘justice’”** and a damage rule is appropriate when, under the facts of a particular case, it most fully serves those ends. In the instant case, considerations of fairness and justice and applicable law mandate the conclusion that the court below, having found that the plaintiff was damaged as a result of the defendants’ fraud, erroneously declined to compensate plaintiff for his full loss. Accordingly, the judgment of the trial court, insofar as it relates to damages, should be vacated, and damages in the amount of the plaintiff’s net trading losses should be added to the damages already awarded.

Dated: New York, New York
April 14, 1977

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**Straus v. Victor Talking Mach. Co.*, 297 F. 791, 802 (2d Cir. 1924).

** *Nordstrom, Damages As Compensation For Loss*, *supra*, at 15.



DAVID E. ROLF,
Plaintiff-Appellant,
-against-
BLYTH EASTMAN DILLON & CO., INC.,
and MICHAEL STOTT,
Defendants-Appellees,
and
AKIYOSHI YAMADA,
Defendant

DOCKET 77-7104

State of New York,
County of New York,
City of New York—ss.:

Mary L. Harnes, being duly sworn, deposes
and says that she is over the age of 18 years. That on the 14th
day of April, 1977, she served 2 copies of BRIEF
FOR PLAINTIFF-APPELLANT DAVID E. ROLF on
BREED, ABBOTT & MORGAN, Esqs., the attorney^s
for defendants-Appellees BLYTH EASTMAN DILLON & CO., INC. and MICHAEL STOTT,
by delivering to and leaving same with a proper person in charge of
the office at One Chase Manhattan Plaza,
in the Borough of Manhattan, City of New York, between
the usual business hours of said day.

Mary L. Harnes
.....
MARY L. HARNES

Sworn to before me this
14th day of April, 1977.

Martin H. Olesh
Notary Public

MARTIN H. OLESH
Notary Public, State of New York
No. 41-4812405
Qualified in Queens County
Commission Expires March 30, 1979